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SUBJECT: RESPONSE: IMPACT OF RISING FOOD/COMMODITY PRICES -- CHINA

REF: STATE 39410

INTRODUCTION/SUMMARY

11. (U) INTRODUCTION: This report is Mission China's response to reftel, which requested input on the impact of food and commodity price increases. It is a composite of analysis and data compiled by Embassy Beijing as well as by Econoffs in Consulates General Guangzhou, Shanghai, Chengdu, and Shenyang. The first part of this message is our formal response within the space limits prescribed by Dept. Given China's large population, size, and significant role in global food demand and production, however, we have additionally included an addendum with more on-the-ground views, largely from the Consulates General. At the end of this report is a list of relevant reftels from this post, sent over the last year. END INTRODUCTION

12. (SBU) SUMMARY: China is not a significant importer or exporter of grains, and the country's recent food price/supply shocks are largely domestic in nature. China is, however, the world's top importer of oilseeds and edible oils, and this has bearing on the prices of these items in other markets. China is also a huge contributor to the world's rising demand for oil; this impacts the global price of petroleum- and natural gas-derived agricultural inputs and increases the economic attractiveness of biofuel crops and production in other countries. China is not a major source of globally traded grain supplies, but it is a significant exporter of some types of produce. The mainland consumer price index (CPI) food basket rose 21% during the first quarter of this year, while overall CPI inflation was 8%; both figures were 11-year highs. Food inflation is expected to moderate over the coming months. Higher prices have adversely affected lower-income consumers who spend a higher proportion of their income on food. Apart from isolated incidents, there is no sign of widespread or sustained instability. Major factors in recent food inflation are domestic pork supply and disease problems, winter storms, and the aforementioned costly imports of edible oils. The Chinese Government has imposed a range of measures to address food inflation, including export tariffs on fertilizer and grains as well as price controls on staple food items. There are also new investment restrictions on some areas of commodity processing and distribution. Key longer-term drivers of China's influence on global food markets include rising incomes raising the caloric intake, limited arable land, and widespread environmental degradation. These factors are expected to increase imports over time, but this trend will likely play out gradually. END INTRODUCTION/SUMMARY

DEMAND

13. (U) China's population growth has slowed dramatically; the current population of 1.3 billion is expected to reach 1.46 billion by 2030. However, continued economic expansion and rising living standards have driven up food consumption from approximately 2,000 cal/day in the 1970's to 3,000 cal/day today. Over the past 20 years, there has been a major shift in the composition of caloric intake, with the grains proportion falling from 70% to 45% and meat/dairy rising from 6% to 25%. China's average GDP growth has been above 9% for a generation and is only gradually expected to slow over the coming years. As living standards further shift intake away from grains and boost overall calorie consumption, a fixed arable land supply with limited potential for increased yields suggests the likelihood of greater imports, perhaps on the order of 15% growth annually in the medium term, according to a report prepared by UBS, with even higher rates for grains.

14. (U) The mainland consumer price index (CPI) food basket rose 21% during the first quarter of this year, while overall CPI inflation was 8%; both figures were 11-year highs. Pork prices alone rose 69% yoy as of February 2008, with beef and lamb not far behind. Food prices account for approximately 87% of the overall CPI increase. Income disparities are very high in China -- the Gini Coefficient is estimated to approach 0.50. Consequently, those in the bottom half of the income distribution -- who spend more of their budget on food than suggested by the 33% CPI weighting -- are adversely affected.

15. (SBU) There is some evidence of product substitution under way. For example, Consulate General Guangzhou reports that low-income consumers in the provinces of Fujian, Hainan, and Guangxi are increasingly substituting cheaper foods, e.g., soy milk for fresh milk. To date, the effect of such substitution has not been obvious in demand growth, and it is most likely only moderating the

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spectacular growth rates we are seeing in milk and meat consumption.

16. (SBU) No discussion of China's impact on the world's rising food and commodity prices is complete without reference to energy demand, which affects fertilizer prices, transport costs, and the incentives for biofuel crop cultivation and production in other countries. China does not produce enough crude oil or natural gas to meet its needs. The International Energy Agency estimates that China's oil imports will grow from 3.5 million bbl/day in 2006 (half of current consumption) to 7.1 million bbl/day in 2015 to 13.1 million bbl/day in 2030, implying that China will account for approximately 40% of the global increase in demand for traded oil over this period.

SUPPLY

17. (U) China is the world's largest producer of agricultural goods and is number one in cotton (27% of world production), rice (31%), apples (52%), peanuts (43%), pears (71%), and pork (51%). It is second in poultry (17%), corn (19%), wheat (16%), citrus (19%), and rapeseed (27%). China is fairly isolated from global markets and prices for grain because it neither exports nor imports a significant percentage of any grain product. This reflects high transportation costs, poor logistics to export terminals, high and increasing domestic demand, and government incentives for local use. China does export seafood, fruits, vegetables, and animal products. It is the world's top importer of oilseeds and edible oils, particularly soybeans, where its high level of imports means that China influences the international market, although it is a price taker.

18. (U) Recent food price inflation primarily reflects domestic supply shocks in both livestock and perishables. Some food inflation is imported, and this is most notably reflected in prices for cooking (soybean) oil. A swine viral infection has sharply reduced pork production over the past two years, and January/February 2008 brought the worst winter weather in 40 years, killing 63 million poultry birds, 4 million pigs, 393,000 cattle, and 1.38 million sheep and goats. The storms damaged the spring 2008 fruit and vegetable crops, and will reduce the harvested

rapeseed area from 7.1 million hectares to 6.7 million. Citrus production is expected to decrease by 10-15%. Overall economic losses from the storms are estimated at \$21 billion. In 2007, a drought cut corn production by 6%. Livestock growth has also pressured the corn supply, lowering increases in corn exports to other markets such as South Korea and Japan.

¶9. (U) China faces significant longer-term supply constraints. Only 14% of land in China is cultivated, and the country is poorly endowed with water resources. Although there is much excess rural labor, there is a significant exodus under way from agricultural areas: approximately 150 million of China's 700 million rural residents have migrated to jobs created by China's manufacturing boom, primarily in coastal areas. The rising cost of inputs such as fertilizers, pesticides, and feed products for livestock means that increased prices are not always translating into expanded margins for farmers. Consequently, supply increases in response to prices are uneven, depending on specific conditions. Agricultural productivity and yields have already increased with economic liberalization and the expanded use of fertilizer. Further gains will not come easily in an environment of small-scale household plots and amidst environmental degradation. Food prices do not yet seem to be a factor in causing an increase in land used in food production or a shift in production from non-food commodities to grains. There appears to have been some response by farmers to high pork prices, but this also is a longer-term trend based on upward demand for pork in China.

¶10. (SBU) A think tank contact in Sichuan Province, an important pig raising center, described supply challenges to us. Many farmers there no longer raise pigs now because of blue-ear disease. Prices of baby pigs are so high that farmers cannot afford them. (Note: We have also heard reference to higher input prices (feed, electricity, transportation), and the inability to find higher paying work in urban centers. End Note.) The contact described a similar situation with rice: many farmers do not store as much grain as before, since family members have left home to go to other provinces as migrant workers; they think they can buy grain if they need it. The contact expressed alarm that stockpiles of grain in government storehouses are the lowest since the 1980s.

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ECONOMIC AND POLITICAL IMPACT

¶11. (SBU) The mainland consumer price index (CPI) food basket rose 21% during the first quarter of this year, while overall CPI inflation was 8%; both figures were 11-year highs. Pork prices alone rose 69% yoy as of February 2008, with beef and lamb not far behind. Food prices account for approximately 87% of the overall CPI increase. Curbing inflation has on numerous recent occasions been declared the government's top economic priority for 2008. This is the strongest bout of agricultural inflation since the early 1990s and the first time in the past 30 years that rising food prices are not part of a more general inflation trend. To date, inflation has not been a major factor in balance of payments or in fiscal spending, nor is it seen as a factor that will alter medium-term growth prospects.

¶12. (SBU) There is no sign to date that food inflation has caused or is about to cause widespread unrest. There have, however, been sporadic incidents of note, such as an occasion when supermarket shoppers stampeded a cooking oil sale (see addendum). Commenting on inflationary trends in their respective localities, government officials and citizens in two provinces outside Beijing recently expressed optimism that prices are stabilizing and said their regions have not so far experienced widespread social unrest or hoarding.

¶13. (SBU) Food inflation has drawn very extensive attention from the top leadership. Over the past eight months, China has been undergoing a change in government and Communist Party leadership; the October 2007 17th Party Congress and March 2008 National People's Congress were key events in this regard, and on both occasions, discussion of managing inflation was prominent. As

statistics have been released, top leaders have gone to great lengths to make themselves visibly responsive, either by announcing new government measures or by visiting with local residents affected by high prices. We are unaware of recent food inflation broadly affecting public attitudes towards biofuels or that it is generating friction between classes. However, contacts in Hebei and Hunan Provinces recently asked Econoff if the United States would reconsider its policy on biofuels because of the recent surge in world food prices.

ENVIRONMENTAL IMPACT

¶14. (SBU) China is profoundly challenged by long-term environmental degradation. Recent food inflation has neither mitigated nor exacerbated this trend in a measurable way. In the longer term however, China may face serious food production problems, especially given that per capita water resources are 25% of the global average, with much of the endowment concentrated in the south. Agriculture accounts for 70% of water consumption, and water quality is deteriorating rapidly. Declining water availability for agriculture in general is a concern of the government. However, favorable weather conditions are a more important factor than the amount of available surface/ground water for irrigation for grain production. expected to negatively impact grain production over the coming decades. The government is spending tens of billions of dollars to build infrastructure to transport water to the north. Although China's water shortages are already acute, it is the long term prospects that look especially daunting, especially with water pricing policies encourages overuse and waste.

GOVERNMENT POLICY RESPONSE

¶15. (SBU) Over the past 30 years, China has been transforming from a command economy to one primarily guided by market signals. Agricultural prices and volumes were formerly determined by the Central Government but are now relatively free and open. A notable exception is grains, where a persistent desire for self-sufficiency has led to the continuation of price supports, subsidies, and trade quotas. The prices of produce and meat are by contrast set without state intervention. China's 2001 WTO accession has reduced tariffs on "non-essential" goods but left in place a TRQ system whereby imports of major grains and commodities are subject to prohibitive tariffs once an import ceiling is reached.

¶16. (SBU) There have been a number of measures taken by the Chinese Government to address food inflation as well as broader inflationary

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trends in the economy:

- o In April, the Ministry of Finance announced a 100% special export duty on fertilizer and related exports for the period April 20 to September 30. This expanded duties already imposed in February.
- o In January, the government imposed price controls on a number of staple products including cooking oil, pork, eggs, instant noodles, milk, and grains.
- o In December 2007, the government removed the export rebate (generally 13%) on wheat, rice, corn, other cereals, soybeans and their derived flour byproducts.
- o In December 2007, a new investment catalogue showed continued concern about foreign participation in the food sector and its perceived impact on food security. The catalogue included restrictions on the seed industry, soybean processing, and distribution services.
- o In January 2008, the government announced provisional export taxes on grains and their flour products as well as an export license regime on flour products to discourage exports.
- o China's ethanol exports rose 500% from 2005-06, leading to

concerns that export oriented ethanol plants might lead to domestic grain shortages. The government responded by eliminating VAT rebates and halted approval of new corn biofuel processing plants; ethanol exports fell 87% in 2007.

- o The urban poor have been hit hardest by rising food prices, and the Central Government is providing subsidies to poor urban residents so that they can purchase pork and eggs.

- o More broadly, the government has adopted a "tightening" policy in response to inflationary trends, including six increases in interest rates since January 2007 and a rise in bank reserve requirements from 10% to 16% over the same period; real deposit rates, however, remain negative.

ADDENDUM

¶17. (U) The following material includes spot reports from Econoffs in our Consulates General as well as Embassy Beijing's Economic Section:

¶18. (SBU) SUPPLY AND DEMAND:

** (Chengdu)

- o Rising incomes in southwest China have led to increasing demand for meat (especially pork) as well as vegetable oil. At the same time, consumers are facing both rising prices and declining quality, especially for pork. From March 2007 to March 2008, prices for important commodities rose dramatically in southwest China's two most important urban areas, Chengdu and Chongqing. A breakdown (information comes from local Price Bureau data, not always reliable but indicative of trends at least):

- Vegetable oil: Chengdu 79%, Chongqing 71%
- Cabbage: Chengdu up 183%, Chongqing 260%
- Pork: Chengdu up 88%, Chongqing 67%
- Eggs: Chengdu down 4%, Chongqing 17%
- Rice: Chengdu info unavailable, Chongqing 59%

- o Rural areas are also feeling the impact of urbanization, industrialization, and migration of farmers to work in other areas. Villages are being emptied out, farmers (staying at home) are getting older, and agricultural production has become a sideline activity. Farmers' enthusiasm for grain production has been hurt because of the high costs they have to cover for grain production. Now some farmers are changing grain farmland into cash-crop land.

** (Guangzhou)

- o Despite data showing increased food prices, averaging 9 percent

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across all food categories in Guangdong, and double-digit percentage increases for household food expenditures throughout Guangzhou's consular district (Guangdong, Fujian, Guangxi and Hainan), the locally-produced supply has not correspondingly increased. Less than half of all food products in Guangdong province are produced locally, and total production levels are between one-half and two-thirds of food supplies in the other three provinces. Food production only increased marginally in 2007, growing by an average of 2-3 percent for most products.

- o Fujian, Hainan, and Guangxi Provinces produce higher percentages of their own food, but demand exceeds supply, and 2007 statistics show that low-income consumers are substituting less nutritious, cheaper foods for more expensive ingredients because of rising food prices. One example is a trend towards consumption of soy milk instead of fresh milk in low income households.

o An important reason for slower supply-side growth is major increases in production input costs -- especially chemical fertilizers and pesticides (mostly based on petroleum-related inputs) as well as feed products for livestock. Many producers have seen profit margins remain the same or decline as the cost of some inputs have risen more quickly than food prices.

o Another reason for slow supply-side growth is the wait-and-see approach among South China farmers, especially pig farmers. This group remains risk-averse after sustaining major losses in 2006 when pork prices were very low; feed and vaccination costs have increased faster than profits; and risks to livestock from disease remain high.

19. (SBU) ECONOMIC/POLITICAL IMPACT

** (Chengdu)

o Stories of food-related unrest are hard to come by here, but one example took place in Chongqing in November 2007, when three people were killed and 31 people injured in an incident at a Carrefour Store. In order to celebrate the 10th anniversary of its store opening, Carrefour had a big sale on vegetable oil, in which the price of a bottle of vegetable oil was reduced by 11 RMB (\$1.50) to from 51 RMB to 39.9 RMB (\$5.32). Early on the morning of the sale, thousands of people were waiting in front of the main gate of Carrefour. Most of them were 60 or older. When the gate was opened, people rushed into the store, and many people fell down in the stampede. Three people were trampled to death, and 31 were injured, seven of them seriously. According to a report released by the Chongqing Statistics Bureau, Chongqing's CPI in Oct. increased by 6.5%, but the price of food in Chongqing including vegetable oil increased by 34%. "The fast increases in food prices and the low income of poor people as well as poor management of Carrefour are the major reasons for the incident," said Mr. Pu Qijun, Director of the Sociology Research Institution of Chongqing Academy of Social Sciences.

o Rising food prices have relatively little impact on high-income families. A contact who is a college professor married to a doctor tells us, "Food prices, especially pork and vegetables, are going up very fast, but our quality of life is not affected." Middle-level income earners face more pressure. Some of them tell us they eat less pork than before, sometimes substituting fish, the price of which is increasing less rapidly. As for low-income families, their living quality has been affected most obviously. A migrant farmer said his wife and he moved to Chengdu last year. Both of them hold temporary jobs and they only earn about 1,200 RMB (\$171) a month. They have to pay the house rent, tuition for their son, and other expense. Previously, they only needed about 300 RMB (\$42) for food per month. But now they said they need at least 500 RMB (\$71). He said they only eat pork on Sunday, and sometimes, they eat some fish.

** Guangzhou

o News reports have surfaced about occasional boycotts and other signs of consumer dissatisfaction, particularly among price-sensitive groups like students. An example was a one-day boycott of a Guangdong university canteen in September 2007, with almost 20,000 students participating, after the government increased campus cafeteria prices 33-50 percent.

o Statistics from each of the four provinces show that among low-income households, those that earn 50 percent or less of the

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local average income, food expenditures .

** Shanghai

o Official data show food price increases in Shanghai roughly on par with the national level (18% yoy in March compared to 21% nationally, although official numbers are widely considered to underestimate actual inflation). Food price inflation has been largely driven by meat/pork prices, which increased by 40% yoy in

Shanghai in March. Prices may have started to stabilize, although it remains unclear how much of this is due to ongoing government intervention. Local media reported the Shanghai Development and Reform Committee implemented temporary price freezes for rice and wheat, vegetable oil, meat, milk and eggs on January 26. Anecdotal evidence from wet markets in Shanghai indicates pork prices have been flat in April (pork increased 67% yoy in March, nationally). In terms of grains, local supermarkets have not raised rice prices materially in the last few months, which is consistent with national level data and also reports that the government has sold some of its stock of reserves.

o Analysts note that there has been no evidence of a significant move by the government to increase imports of pork or other meat products to ease supply constraints, leading some to conclude that the government is comfortable with its policy response. In terms of policy measures, a pork vendor in Shanghai explained that financial incentives to shift farmers to pig production in Zhejiang have not yet had much success because farmers believe the intermediate food distributors have pricing power. On the demand side, subsidies from the Shanghai Municipal Government have allowed local universities to keep prices at school cafeterias fixed.

120. (SBU) ENVIRONMENTAL IMPACT

** Guangzhou

o Guangxi Province suffered crop and farmland damage as a result of severe winter storms and a drought last summer. However, despite the losses last summer, Guangxi was able to increase total crop production in 2007 due to subsidies and better technology. Hainan, Guangdong and Fujian Provinces regularly suffer typhoon-related agricultural losses, and this year's typhoon season has started no differently with an early storm that damaged farms in Hainan and Guangdong.

121. (SBU) POLICY RESPONSE

** Chengdu

o Comments from a think-tank contact: Local governments offer agricultural subsidies to farmers in Sichuan. On average, each farm household can get 280 RMB per year. The Central Government's purpose in providing such subsidies is to encourage farmers to engage in agriculture production. However, the policy still has problems. Subsidies are offered according to how much land a household has. As a result, many farmers receive the subsidy even if they no longer farm. The policy should be changed, that is, only those who do farm production should get the subsidy. It is good that the agriculture tax and other fees have been abolished. But more and more farmland is going out of cultivation since many migrant farmers don't care about it. In the past, they had to think more about the taxes they must pay, and would keep their farmland in production.

** Guangzhou

o Fujian and Guangxi both announced major government programs to increase agricultural production including more funding for subsidies, farmer training and relief programs. South China's provincial and local governments have implemented stronger price controls on certain basic food products and agriculture inputs like fertilizer.

REFERENCE TELEGRAMS

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Beijing 870: NPC: Food Inflation Rural Sector's Main Concern

Beijing 823: NDRC Chairman: Slowing Investment Growth, Fighting Inflation Key Challenges in 2008

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Beijing 809: Premier's NPC Report Pledges More Reform, Tackles Tough Social, Economic Problems

Beijing 750: More Attention to the Rural Sector: Will It Be Enough?

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